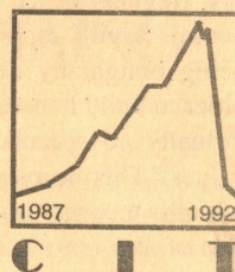


CENTRE FOR INCENTIVE TAXATION ECONOMIC INTELLIGENCE

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MAJOR PLAGUED BY ROCKY BOTTOM

JOHN MAJOR'S government believes that the UK economy is on the mend. Various statistics, some of them adjusted to give the best possible complexion on underlying trends (such as the figure for unemployment), appear to suggest a turning point. Is the Prime Minister being rash, in claiming that Britain is "on the turn"? Ought he to heed the words of *Financial Times* columnist Samuel Brittan (Nov 11, 1992): "Never forecast a turning point because it will probably not occur in the year in question"?

Economists have had their reputations severely blow-torched by their forecasting failures of the past five years. Not so EI: back in 1988, when everyone else was looking at the UK economy through rose-tinted spectacles, EI emphatically declared 1992 as the turning point. We were right. So what is our verdict on Premier Major's claim that Britain has now put the worst behind it? He is correct, but for the wrong reasons. His claim is based on hope, rather than grounded in a theory that reflects the way the economy really works.

EI's model of the economy draws heavily on trends in the way that ALL factors of production are costed and used: labour, capital and land. The reason our forecasting record is superior to anyone else's is that we incorporate into our expectations the activity in the land market, which is ignored by the other models. So what does the land market tell us about contemporary trends?

The index on residential land prices produced by

Savills, a major London real estate agency, tells the story. It does not rely on data from the Department of the Environment but analyses the changes in the market value of 150 sites throughout England, to provide it with a sharper view of trends in land prices.

Savills started their index a year after EI warned that land prices had a macro-economic impact that was escaping other analysts. So why did Savills publish in 1989? Explains Ms Yolande Barnes, Head of Residential Research: "Developers couldn't afford

to compete in the land market, at that time. We also felt that the market had over-heated. Without reliable data, one cannot look at the reasons why it might have overheated, and why land values have fallen by 60% in value."

Ms Barnes, who started the index, saw that land prices were crucial in the housing sector: "About one-third of the price of new houses is land cost. At the time when we set up the index, land prices had rocketed; and were in many cases affecting the business of our developer client base."

So what about current prospects for housing, - a leading sector of the modern economy? The Savills data shows that, across the country, land prices have finally stabilised. In the

last six months, they rose in the north and west (up 6% in both regions), where land speculation was at its weakest during the second half of the 1980s; but they continue to weaken in the east and south-

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**Savills' Residential Building
Land Price Index**

	England Index %		South East Index %	
1979	100.0		100.0	
1980	112.2	12.2	109.8	9.8
1981	119.0	6.1	114.2	4.0
1982	132.3	11.2	126.3	10.5
1983	160.2	21.1	146.9	16.3
1984	195.6	22.1	187.4	27.6
1985	234.3	19.8	225.1	20.1
1986	354.4	51.3	317.0	40.9
1987	622.5	75.7	557.7	75.9
1988	1033.5	66.0	854.9	53.3
Jun 89	817.2	- 20.9	664.1	- 22.3
Dec 89	627.2	- 23.3	458.3	- 31.0
Jun 90	520.5	- 17.0	394.2	- 14.0
Dec 90	426.5	- 18.1	337.4	- 14.4
Jun 91	415.4	- 2.6	335.5	- 0.6
Dec 91	402.1	- 3.2	325.4	- 3.0
Jun 92	393.7	- 2.1	310.5	- 4.6
Dec 92	400.9	1.8	308.1	- 0.8

SOURCE:

Savills Residential Research, June 1993

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east (regions which led the land boom). Savills reports: "Land is being bought by developers in order to build houses and there is virtually no speculation in land values." This means we can expect a patchy recovery in the construction of new houses, with demand from first-time buyers in the outer regions leading the way to recovery in the residential sector.

The trends in land prices, then, confirm the thesis presented by EI in 1988: that land prices - under present tax arrangements - play a crucial role in determining the fate of the economy. Alas, the Treasury's new "Seven Wise Men" team of independent economists, who are now supposed to provide the government with better insights into the workings of the economy, have not yet incorporated this lesson into their analytical frameworks.

OVERALL, the UK economy will now grow at a painfully slow rate. The Treasury has revised its forecast upwards. But the pace of recovery will be negatively affected by government policy.

On the long-term trend, Savills predict: "As demand for housing picks up, so too should turnover in land. Big increases in value such as those in the late 1980s are unlikely to occur in the short term due to the absence of speculative trading potential. However, given the fundamental shortage of buildable land due to planning restrictions, it is perhaps inevitable that speculation will return in the longer term."

The land-led boom/slump will indeed return: for EI's long-term forecast, see EI/37. That cycle, however, has nothing to do with planning systems, and everything to do with fiscal policy (see p.4).

ROLL UP FOR MONOPOLY!

REFORM of the trading system is high on the political agenda, but western governments advocating free trade are defining a strategy that is likely to create a new phase of unemployment. The tensions are most likely to surface most dramatically in those Third World countries that formerly operated on the basis of socialist principles.

VIETNAM is a case in point, where students are being taught "market economics" on the basis of a board game - Monopoly. The game teaches you how to corner the market in real estate, and penalise people for trespassing on your property. "They love it, you just couldn't tear them away," reports Suzanne Hosley, one of the teachers at the National Economics University in Hanoi.

The version used in Hanoi is set in Hong Kong, but it does not instruct the Master of Business Administration students that the land in the British Colony is all owned by the Crown. Students are merely led to believe that the game represents the workings of the market economy.

An indication of the impact of that system of economics is already being felt in the countryside where, according to reporter Nick Cumming-Bruce (*The Guardian*, July 19): "...observers already see signs of a return to 'landlordism' as those with money acquire control of large tracts of land and those without are reduced to selling their labour".

Memories, it seems are short; rural landlordism created the discontent that gave the edge to the Vietcong in the war which, 18 years ago, the United States realised it could not win.

Under Vietnam's 1992 constitution, all land belongs to the people. But a new law creates all the features of private ownership, with no provision to make users pay the market rent for the benefits received from their monopoly of land.

In INDIA, US economists are advising the government to hivel off bankrupt state-owned enterprises, without explaining how to generate additional jobs to compensate for the massive lay-offs that would follow.

Trouble will begin when India opens up her market by cutting import duties and promoting inward investment. The rationalisation of uncompetitive industries will lead to massive unemployment, which will add to the geopolitical stresses

of a region that is prone to resolving problems by turning to open conflict with neighbours. Migration is also likely to add to social tensions in host countries, especially in Europe where right wing nationalist groups have surfaced to blame immigrants for the social discontent caused by unemployment.

The Indian government and its western advisers are not able to define a strategy for full employment. So while the wealth of the rich is likely to increase, as a result of increases in productivity, the pressure on wages will increase the state of poverty. The best prospects for investors is in the large cities: rents will increase on a massive scale as landowners find the bargaining power shifting further in their direction.

Look no further than MEXICO for what will happen in these countries. The prospects of free trade with the USA has not led so much to a boom in productivity-increasing capital goods - more a rush to carve up the land market.

Mexico City, which accounts for 37% of the country's GDP, is the focus of a construction boom last seen in places like London's Docklands. Santa Fe, a 2,000-acre/\$10 billion project just outside the city's most exclusive residential neighbourhoods, is pulling in the investors who have already forgotten that land speculation in the '80s caused the oversupply of buildings in Europe and North America.

One of the surprising newcomers is George Soros, the currency speculator who is advised by Reichmann International (the Reichmann brothers lost their shirts in Docklands). Soros Realty has agreed in principle to a \$500m slice of the Santa Fe property trap.

Mexican banks are also heading for a heavy fall. Their loans to construction, which were formerly under 2% of total loans, have now soared above 8%. But the banks could not resist the numbers: average rents have doubled. The fact that vacancy rates have already started to climb is (as usual, near the top end of a land boom) conveniently ignored.

When Mexico City's economy crashes, many people in the rest of the country will lose their jobs. Many of them will then head north for the border, hoping for salvation in the USA, bringing with them added social pressures to tax the ingenuity of President Clinton's tax-raising strategists.